Asset Class & Investment Outlook - Q1 2016

Asset/Investment Area	Income (Current Yield)	Rising Income	Long Term Real Capital Growth	Volatility	Inflation Protection	Currency Risk	Commentary
Cash	1.00%	Potentially	Negative	Very low	No	No	*UPDATE: Domestic economic strength should give the Bank of England leeway to raise rates following the US, although any increases are likely to be modest. Inflationary pressures remain low.*
Conventional Gilt	1.81%	No	Negative	Some	No	No	*UPDATE: Gilts remain extremely overvalued. Whilst performance remained fairly stable in 2015 this cannot continue indefinitely and at some point prices will correct and yields will rise, creating irreversible capital losses for some. We are still negative on this sector and this view will not change until a correction has taken place and valuations come to more reasonable levels.*
Index-Linked Gilt	1.88%	Yes	Negative (at present)	Some	Yes	No	*Inflation remains very subdued and CPI inflation was negative or close to zero throughout 2015. FTSE Actuaries data indicates that these bonds remain very fully valued across all maturities with correspondingly low yields. The market is also distorted by "price insensitive buyers" such as pension funds and insurance companies where liabilities need to be matched. We remain negative on these bonds based on valuation.*
Sterling Corporate Bond (Investment Grade)	3.20%	No	Negative	Some	No	No	*UPDATE: Sterling corporate bonds performed well in 2015 as a decline in the amount of new debt issued boosted the price of outstanding paper and changes to pension law drove demand for longer dated debt. Valuations remain high and liquidity remains untested. We therefore retain our negative view on this sector.*
Sterling Corporate Bond (High Yield)	4.56%	No	Negative	High	No	No	*UPDATE: Recent sell-offs have improved valuations but overcrowding in the market is creating liquidity risks as monetary policy is tightened. Two high yield bond funds in the US suspended redemptions in December due to a high level of sales ahead of the US interest rate rise and a number of exchange-traded funds fell sharply. We remain very negative on this sector.*
International Corporate Bond	2.34%	No	Negative	High	No	Yes	*UPDATE: Spreads have widened compared to investment grade and sovereign debt but yields remain low and prices therefore remain elevated. There has been a reduction in demand for corporate debt as evidenced by the failed LBO of Veritas by private equity firm Carlyle and the failure of Vodafone to issue a 30-year USD bond in November 2015. Liquidity in the secondary market is untested. There were over 100 defaults globally in 2015, compared to 60 in 2014. This is the highest number for six years, and the trend is expected to continue in 2016. Bearing all of these elements in mind we retain a negative view.*
Emerging Corporate Bond	4.74%	No	Negative	Very high	No	Yes	*Slower economic growth, a strong US Dollar, weaker commodity prices and the US interest rate rise have all increased the likelihood of default in the emerging market debt sector. There may be idiosyncratic opportunities but we remain negative on this sector due to its volatility, poor liquidity and ongoing currency risks.*

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UK Equity (Equity Income)	4.07%	Yes	Yes	High	Yes, med term	No	*UPDATE: UK Equity Income once again proved defensive during periods of market volatility in 2015. Taking the big picture, it is interesting to note that according to data from Seneca, the UK equity market's dividend yield has undulated in the 3-5% range over the last 20 years, whilst the real long bond yield has fallen from 4% to -1%; this is a good illustration of why we prefer equity income strategies to bonds from an asset allocation point of view. We are mindful of the concentration of dividend payments among the largest companies in the UK and of declining cover and payout ratios at the aggregate level but the Equity Income funds we invest in have a focus on sustainable dividends. This automatically excludes a number of companies, especially in the resources sectors, where dividends will be tested in the coming year.*
UK Equity (Other)	3.63%	Yes	Yes	High	Yes, med term	No	*Strong economic data is providing some support to markets, although there is a disconnect between the UK economy and UK stock markets because the FTSE 100 and FTSE 250 constituents source less than half of their revenues from the UK. Therefore, resources companies and those with Asia/emerging markets business lines have been impacted by the large scale stock market correction in China, highlighting the need to choose well-diversified funds within the sector, which include some companies that are smaller and more domestic in focus. We retain a neutral view based on valuations.*
Global (Equity Income)	2.82%	Yes	Yes	High	Yes, med term	Yes	*UPDATE: Many global income stocks are very fully valued because investors have switched from bonds to income generative equities in the hunt for yield. Income growth is facing headwinds including a lack of earnings growth and the currency effects of a strong Dollar and a weak Euro. Whilst we are always vigilant for signs of dividend cuts, given the large allocation to the US in most of our funds in this sector it is comforting to know that in the last 50 years aggregate dividends in the US fell only during the financial crisis, and even then the falls were concentrated in one sector, financials. Taking a long term view we remain selectively positive on this sector and we continue to invest in a range of funds which are complementary and diversified with a focus on achieving total returns from a portfolio of high quality equities. We are keeping a close eye on the more cyclically focused funds in our roster.*
European Equity	2.56%	Yes	Yes	High	Yes, med term	Yes - €	*UPDATE: There are some signs of recovery in Europe, but unemployment remains high, especially among young people. The outlook for 2016 is an uneven recovery with growth averaging just over 1%. Low inflation, large amounts of debt, and a lack of structural reform in the financial sector all represent headwinds to growth. Quantitative easing has lifted asset prices, but the real economy has yet to follow. We therefore retain a cautious stance on Europe.*
North American Equity	1.58%	Yes	Yes	High	Yes, med term	Yes - $	*UPDATE: Continued economic growth, especially tighter labour markets, should enable the Federal Reserve to raise interest rates throughout the coming year. Share buybacks and dividends have supported markets but valuations remain expensive on some metrics and profit margins are likely to compress as wage growth accelerates. Additionally, the market is increasingly bifurcated, with nearly all growth in 2015 centred upon 9 stocks including E-Bay, Amazon, Netflix, Google, Microsoft, Starbucks and Facebook. Without their influence the market would have made a loss in 2015. We therefore retain a slightly negative view.*
Asia ex Japan Equity	1.69%	Mixed	Yes	Very high	Yes, med term	Yes	*UPDATE: China continues to affect all markets within the region. Attempts by the Chinese market to correct itself have been hampered by government interference. China is having to face up to the effects of excessive bank lending to capital projects and to frictional problems as the government tries to switch the economy towards consumption and services and away from manufacturing. We retain a very cautious view on Asia because of the ramifications of the correction in China and remain focused on funds which employ bottom-up stock picking to identify high quality companies with sustainable business models.*

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Japan Equity	1.34%	Mixed	Yes	High	Yes, med term	Yes - ¥	*UPDATE: Japanese equity markets performed well in 2015 fuelled by quantitative easing. Earnings upgrades because of the weaker yen, improving corporate governance and lower corporate taxes also assisted. We remain negative on this market because structural reforms have yet to be implemented. Additionally, consumer price inflation remains stubbornly low, debt levels rise ever higher and negative demographics are a serious issue.*
Emerging Market Equity	2.39%	Mixed	Yes	Very high	Yes, med term	Yes	*UPDATE: Emerging markets had a torrid 2015. The commodity price slump has badly affected Brazil, while there is political uncertainty in Eastern Europe and large behavioural factors are affecting the Chinese market. Rather than attempting to pick "winners" from this diverse group of markets and economies we continue to prefer to gain exposure to emerging markets indirectly through high quality developed market companies that derive a proportion of their revenues from these countries.*

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UK Commercial Property	2.80%	Yes	Yes	Cyclical	Yes	No	*Robust economic growth continues to bolster prices in the near term and yields remain attractive compared to fixed interest, but unimpressive compared to what could be achieved through investment in a good quality UK or global equity income funds, especially once taxes and charges are taken into account. We therefore remain neutral.*
Listed Infrastructure	1.93%	Yes	Yes	High	Yes, med term	Yes	*UPDATE: Freight rail, airports and toll roads have benefited from economic recovery and have outperformed utilities and pipelines which have been influenced by rising interest rates and falling oil prices respectively. Strong global demand for infrastructure assets has been highlighted by the substantial multiples paid for electricity assets in Australia and by strong interest to privatise the airports in Nice and Lyon. We remain neutral based on valuation because a lot of money has flowed out of fixed interest and into infrastructure buoying prices.*
Commodities	0.00%	No	Yes	Extreme	Yes, med term	Yes	*Various factors influence individual commodity prices including US dollar appreciation, Chinese demand, Middle East tensions and climatic conditions. Oil prices dropped dramatically in 2015 and have yet to recover. Gold prices are now around $1,100, significantly below the peak of over $1,800 in 2011. We retain our negative view on commodities based on their volatility and the difficulties of obtaining exposure to them with limited physical ETFs available and with a negative house view on synthetic ETF strategies.*

Notes:

Terms positive and negative represent our current tactical allocation adjustments to an established and well diversified portfolio. No base asset allocation stipulated.

The yield to maturity figure for various fixed income ETFs has been used as a proxy for yields within most sectors.
This metric is calculated by aggregating the yield statistics for each of the securities that make up a bond ETF and is, therefore, reflective of yields within the market.
Yield figures have been compiled as follows:
Conventional Gilt - Yield on Vanguard UK Government Bond Index fund
Index-Linked Gilt - Yield on iShares £ Index-Linked Gilts ETF
UK Corporate Bond (Investment Grade) - Yield on Vanguard Investment Grade Bond Index fund
UK Corporate Bond (High Yield) - Average yield of funds in IA Sterling High Yield sector.
International Corporate Bond - Yield on PowerShares International Corporate Bond ETF
Emerging Corporate Bond - Yield on iShares JPM $ Emerging Markets Bond ETF
UK Commercial Property - Average of the Yield on Aviva Property Trust, Aberdeen Property Trust, M&G Property Portfolio, Henderson UK Property, F&C UK Property and L&G UK Property Trust
Infrastructure - Average of yield on First State Global Listed Infrastructure, CF Canlife Global Infrastructure and CF Macqaurie Global Infrastructure
UK Equity Income - 110% of the FTSE All-Share yield
UK Equity (Other) - Yield on Vanguard FTSE UK All-Share Index
Global (Equity Income)- 110% of the FTSE All-World yield
European Equity - Yield on Vanguard FTSE Developed Europe ex-UK (Benchmark: FTSE Developed Europe ex-UK Index)
North American Equity - Yield on Vanguard US Equity Index Fund (Benchmark: S&P Total Market Index)
Asia Ex Japan Equity - Average yield of funds within the Asia Pacific Excluding Japan IA sector
Japan Equity - Yield on Vanguard Japan Stock Index (Benchmark: MSCI Japan Index)
Emerging Market Equity - Yield on Vanguard Emerging Markets Stock Index (Benchmark: MSCI Emerging Markets Index)
Commodities - TR/Jefferies CRB Index

Dewhurst Torevell & Co. Ltd, 5 Oxford Court, Manchester M2 3WQ. Tel. 0161 281 6400. www.dewhurst-torevell.co.uk

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